

Policy Effects on Aggregate Supply

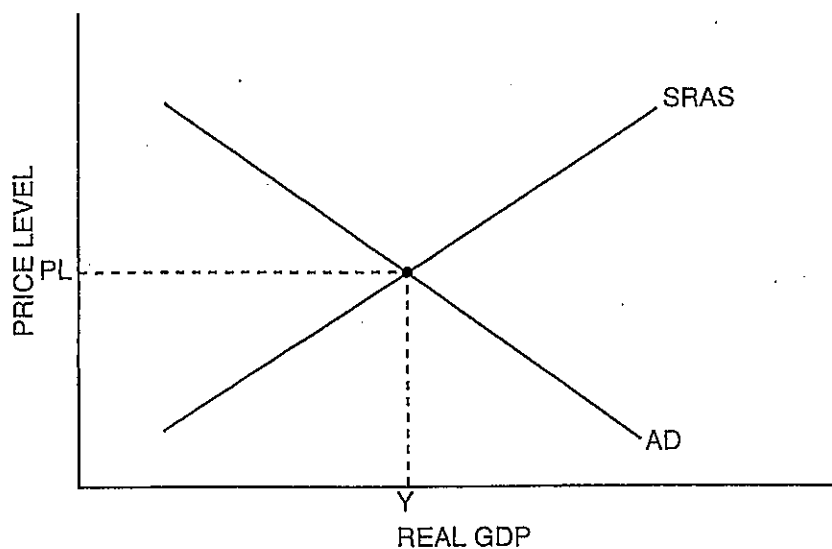
Fiscal and monetary policy affect the economy through changes in aggregate demand (AD). There are also policies that can affect the short-run aggregate supply (SRAS) and long-run aggregate supply (LRAS). Any policy that changes a determinant of SRAS or leads to long-run economic growth will affect the macroeconomy through the supply side. The determinants of SRAS include changes in economy-wide input prices (like wages and the price of oil) and productivity. Factors that affect the LRAS include increases in available resources, higher quality resources, or technological advances.

1. Assume the government grants businesses a substantial tax credit on capital investment. Circle the correct symbol (\uparrow for increase, \downarrow for decrease) to indicate what will happen to the following as a result of the tax credit.

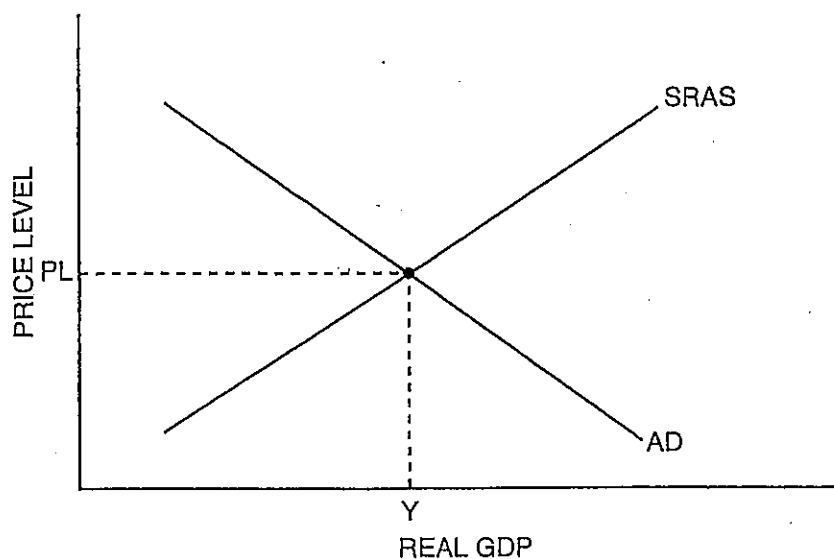
(A) Capital investment	\uparrow	\downarrow
(B) AD	\uparrow	\downarrow
(C) The amount of capital available to labor	\uparrow	\downarrow
(D) Productivity	\uparrow	\downarrow
(E) Firms' unit cost of production	\uparrow	\downarrow
(F) SRAS	\uparrow	\downarrow
(G) LRAS	\uparrow	\downarrow
(H) Real gross domestic product (GDP)	\uparrow	\downarrow

2. How will a decrease in business taxes affect firms' per unit costs?

3. Use the AS/AD diagram below to show the effect of a decrease in business taxes on SRAS, real GDP, and the price level.



4. How will firms' unit cost of production change when there is an increase in government regulation? (*Hint: compliance with regulations creates a cost for firms.*) Use the following AS/AD diagram to show how an increase in regulations on firms affects SRAS, real GDP, and the price level.



Assume that the economy suffers a negative supply shock and that input prices are completely flexible. In the absence of any fiscal or monetary policy, explain how the economy will return to full employment. To help you reach the correct conclusion, answer the following questions.

5. Immediately following the supply shock, what happens to unemployment?

6. How will high unemployment in the economy affect both product prices and wages if prices and wages are completely flexible?

7. How do firms respond to a decrease in input prices?

8. What effect will firms' response to the decrease in input prices have on SRAS?